sifma
Invested in America

H.R. 992, "Swaps Regulatory Improvement Act"

Sponsor(s): Randy Hultgren (R-IL)

Co-Sponsors: Jim Himes (D-CT), Richard Hudson (R-NC), Sean Maloney (D-NY)

Section 716 of the Dodd Frank Act was added at a late stage in the process and was not debated or considered in the House of Representatives. It requires banks to "push out" certain swap activities in separately capitalized affiliates or subsidiaries by providing that a bank that engages in such swap activity will forfeit its rights to the Federal Reserve discount window or FDIC insurance.

This provision has been opposed by senior prudential regulators. Federal Reserve Chairman Ben Bernanke states that "forcing these activities out of insured depository institutions would weaken both financial stability and strong prudential regulator of derivatives activities." Former FDIC Chairwoman Sheila Bair said that "one unintended outcome of this provision would be weakened, not strengthened, protection of the insured banks and the Deposit Insurance Fund."

This provision will also increase the cost to banks to providing customers with swap products. U.S. corporate end users will face higher prices for the instruments that they need to hedge risk of the items they produce. In testimony in front of the House Financial Services Committee in February, Bernanke said that 716 "will likely increase costs of people who use...derivatives."

H.R. 992 modifies Section 716 of the Dodd-Frank Act by requiring only structured finance swaps based on asset-back securities to be pushed out of banks and not applying 716 to equity or commodity swaps. The net effect of these changes is to expand permissible swap activities within a bank and to only exclude swaps based on asset-backed securities that are un-regulated and not of a credit quality established by regulation.

This bill substantively mirrors the final version of H.R. 1838 from the 112th Congress, which was unanimously approved by voice vote in the House Committee on Financial Services.

H.R. 992 has been referred to the House Agriculture and Financial Services Committees.

Joint Economic Committee Hearing on the Economic Outlook
May 22, 2013

Sen. Toomey:
That's possible. A quick follow-up to comments you've made in the past about the swaps push-out provision in Dodd-Frank. I have legislation to allow that much -- not all, but much of that activity that's currently required to be pushed out to the curb back in the banks, which I think is a better way for financial institutions to manage risk and a better way for end-users to be able to use these products. Do you still share the view that it's a good idea to repeal parts of the swap push-out?

Bernanke:
Yes. ***We had -- the Federal Reserve had concerns about this prior to the enactment of the law, and we still have concerns about it.***

House Financial Services Committee Hearing on Monetary Policy and the State of the Economy
February 22, 2013

Rep Himes:
I was very interested in the exchange that you had in the Senate, I believe yesterday, on the topic of Dodd-Frank.
Senator Crapo, I think, asked to you reflect on what elements of that legislation you thought were good and perhaps which elements could stand improvement or that this institution should perhaps revisit.
And I think you highlighted -- you specifically highlighted Section 716 as an area that you thought perhaps we could -- we could revisit.
I wonder, could you elaborate a little bit on -- on 716? But also I'd love to have you extend that discussion, just based on what you've done in the last couple of years what other areas do you think we perhaps may have gotten wrong? And -- or we -- or perhaps, we've, you know, are experiencing unintended consequences or have created problems for the regulators in terms of implementation?

Bernanke:
Well, 716 requires the push-out of certain kinds of derivatives, which means the banks can't manage those derivatives, they have to be in a separate -- a separate company, a separate affiliate. ***And it's not evident why that makes the company as a whole safer. And what we do see is that it will likely increase costs of people who use the derivatives and make it more difficult for the bank to compete with foreign competitors who can provide a more complete set of services. So there are some concerns about that particular rule.***

I think more generally, though, we want to ask the question, can we achieve the same objectives more efficiently, more -- more cheaply. And a -- a review of some of the different elements would be, I think, useful. And a number of people have mentioned concerns about community banks and small institutions. And I think an inventory -- a broad inventory of the regulations affecting small banks would be worth doing in order to try to assess whether there are places where we can simplify, reduce the burden for those banks.

Senate Banking Committee Hearing: Semi Annual Monetary Policy Report
February 26, 2013

Sen. Crapo:
Well, thank you. I -- I probably would disagree with both those conclusions. I know a number of my colleagues are going to get into this issue a little further, so I'm going to go on because of the shortness of time. I want to talk with you briefly about Dodd- Frank reform. If we were able to achieve some bipartisan consensus on steps to improve Dodd-Frank, what are some of the provisions that you think need clarification, or improvement for reconsideration?

Bernanke:
Well, first as a general matter, Senator, Dodd-Frank is a very big, complicated piece of legislation that addresses many different issues. And I'm sure there are many aspects of it that could be improved in one way, or another. I recall in fact, that you yourself had a bill five or six years ago on reg reform and simplification, which was a bipartisan effort to find ways to reduce costs without losing the purposes of the regulation. And I think something along those lines would be very doable in this context. The Federal Reserve would certainly be willing to work with you closely. In terms of specifics, we'd want to do the work of course, but you mentioned in your opening remarks, the end user issue? Clarity on what Congress would like us to do about end users, for example. ***Another area, which is proving difficult, is the push out provision for derivatives.***

Opposition to Section 716 "Swaps Push Out Rule"

"We did need 60 votes in the Senate and Senator Lincoln was one, we hoped. This provision [Section 716] added nothing in terms of protection. I want to reassure people passing this bill [H.R. 1838], particularly as amended, will not in any way, shape or form reduce sensible regulation in derivatives; it will not increase any exposure to the financial system from derivatives. It was an unnecessary and I think unwise amendment [Lincoln amendment]. This bill before us, particularly as amended, will restore this to what I think is the appropriate balance."

Rep. Barney Frank, House Financial Services Committee Markup of H.R. 1838
February 16, 2012

"I'm not opposed to clarifying or changing parts of Dodd-Frank that won't work as we intended or that will have unintended consequences...I think the compromise language [Himes, Maloney, Hayworth amendment to H.R. 1838] which we are considering today strikes the right balance and I urge my colleagues to support that approach."

Rep. Maxine Waters, House Financial Services Committee Markup of H.R. 1838
February 16 2012

"My opposition to the Senate-added swaps "push-out" provision, Section 716, was based solely on the fact that it was wholly at odds with two central tenets of the Dodd-Frank Act, reducing systemic risk and increasing derivative market-transparency...The "push-out" provision would have forced dealer banks to push their swaps businesses out of their heavily regulated and capitalized insured depository institutions and into a less-regulated affiliate, or even worse, outside of the U.S. regulatory-jurisdiction and therefore outside of federal jurisdiction altogether."

Rep. Gary Ackerman op-ed in Salon
December 6, 2011

"We agree with leading regulators and Administration officials, including former Chairman Volcker and current Federal Reserve Chairman Ben S. Bernanke, Treasury Secretary Timothy F. Geithner, SEC Chairwoman Mary L. Schapiro and FDIC Chairwoman Sheila C. Bair, who have all expressed opposition to Senate Section 716 – also known as the "swaps desk spinoff" – that would increase systemic risk by forcing derivatives transactions into less regulated and less capitalized institutions and impede effective regulatory oversight of the derivatives markets. Legitimate conflict of interest concerns are addressed by the ban on proprietary trading in the Volcker Rule, and, accordingly, we believe Section 716 should be removed from the legislation."

New Democrat Coalition letter to the House Financial Services and Senate Banking Committees
June 16, 2010

"If enacted, this provision would require that some $294 trillion in notional amount of derivatives be moved outside of banks or from bank holding companies that own insured depository institutions, presumably to nonbank financial firms such as hedge funds and futures commission merchants, or to foreign banking organizations beyond the reach of federal regulation."

"...it needs to be pointed out that the vast majority of banks that use OTC derivatives confine their activity to hedging interest rate risk with straightforward interest rate derivatives. Given the continuing uncertainty surrounding future movements in interest rates and the detrimental effects that these could

have on unhedged banks, I encourage you to adopt an approach that would allow banks to easily hedge with OTC derivatives."
Former Federal Deposit Insurance Corporation (FDIC) Chairman Sheila Bair in letter to the Senate Banking and Agriculture Committees
April 30, 2010

"...section 716 would essentially prohibit all insured depository institutions from acting as a swap dealer or a major swap participant–even when the institution acts in these capacities to serve the commercial and hedging needs of its customers or to hedge the institution's own financial risks. Forcing these activities out of insured depository institutions would weaken both financial stability and strong prudential regulation of derivative activities."

"Depository institutions use derivatives to help mitigate the risks of their normal banking activities. Use of derivatives by depository institutions to mitigate risks in the banking business also provides important protection to the deposit insurance fund and taxpayers as well as to the financial system more broadly. Thus, banks are well situated to be efficient and prudent providers of these risk management tools to customers."

"...foreign jurisdictions are highly unlikely to push derivatives business out of their banks. Accordingly, foreign banks will have a competitive advantage over U.S. banking firms in the global derivatives marketplace, and derivatives transactions could migrate outside the United States."
Federal Reserve Chairman Ben Bernanke in letter to Sens. Chris Dodd, Richard Shelby, and Kirsten Gillibrand
May 13, 2010

"The provision of derivatives by commercial banks to their customers in the usual course of a banking relationship should not be prohibited...My sense is that the understandable concerns about commercial bank trading in derivatives are reasonably dealt with in Section 619..."
Former Federal Reserve Chairman Paul Volcker in letter to Sen. Chris Dodd
May 6, 2010

"I don't see the need for a separate rule regarding derivatives, because the restriction on banks engaging in proprietary activity would apply to derivatives."
Rep. Barney Frank
May 25, 2010

"I will say this, many of my concerns regarding the margin and capital rules hinge on the definition of swap dealer...I am frustrated that today's proposal has paid such little attention to the swap dealer banks that are captured by the Section 716 "push-out" rule and will be regulated by the Commission, within two years. While I find no justification for the lopsided treatment of end-users throughout the bank regulators margin proposal, I certainly would have preferred that they not require end-users to post margin to "push-out" swap dealers during the 24-month transition period."
Commodity Futures Trading Commission (CFTC) Commissioner Scott O'Malia
Open Meeting to consider Dodd-Frank rulemakings; Margin rule proposal
April 12, 2011

November 14, 2011

Congressman Scott Garrett
Member, House Financial Services Committee
2244 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Garrett:

As the Committee considers legislation proposing changes to the financial reform law, I wanted to bring your attention to a specific concern in Title VII and share my views on the related legislation. As I noted at the time of its passage, and have stated since, I believe the Dodd-Frank reforms were important measures taken to strengthen elements of our financial system and bring more confidence into the markets and institutions. While some of the reforms are currently in place, many still need to be finalized in the rule-making process. With any measure as far-reaching and robust as this law is, refinements to it can prove necessary over time, especially given the broad array of complex issues addressed.

The Title VII provisions in Dodd-Frank are among the most meaningful reforms but with far-reaching implications to the economy. Greater transparency in derivatives transactions and clearing requirements are notable improvements that will be realized as they become operational. How financial institutions interact with their counterparties to provide access to capital and manage risk is a critical feature of our system for all market participants.

As the legislation was being considered, one provision that was among the more notable was Section 716, or the Lincoln swaps push-out proposal. This part of the law effectively requires that financial firms conduct certain derivatives transactions outside of the bank institution and in some other entity within the company. I have significant concerns with this part of the law because of its potential to increase systemic risk, create major inefficiencies in markets, and likely have a major impact on U.S. competitiveness.

One of the primary objectives of the financial reforms enacted after the 2008 failures was to provide for a way to resolve large financial firms should a similar crisis develop in the future. The resolution authority section of the law was crafted to do so, but Section 716 works against that goal. It does so because it causes firms to segment the derivatives with individual counterparties and requires that another entity be created to engage in the pushed-out transactions. Creating new operations, and expending additional capital to make them robust enough, is in contrast to the resolution planning objectives of eliminating entities and simplifying structure. During the winding down of either the financial institution or of the counterparty, the breaking up of the derivatives activities creates additional risks because separate entities will not be able to net their exposures as they can if they are facing one entity only. As noted by some of the prudential regulators in letters objecting to this provision, Section 716 would create significant complications and counter the efforts to resolve such firms in an orderly manner.

For those who argue the Lincoln provision is needed to guard against any future taxpayer bailout based on derivatives, it is important to note that this goal is accomplished by the resolution authority section of the law, thus making Section 716 unnecessary. Indeed, many provisions in the law limit derivatives risk without the need for the push-out provision. The entirety of Title VII is intended to create central counterparties to remove bilateral risk, to create extensive margin requirements on uncleared swaps where bilateral risk may still exist, and to fully enhance risk management of derivatives. Additionally, there are prohibitions on the Federal Reserve creating any assistance program that does not have broad-based applicability – so the regulators cannot subjectively choose one entity anymore for any sort of capital infusion.

With respect to competiveness, no other foreign jurisdiction has indicated it will likely consider a measure like Section 716. As such, U.S. financial firms will most certainly be at a competitive disadvantage relative to their foreign competitors because Section 716 does not apply to those foreign firms. U.S. firms transacting with counterparties in this country and abroad provide critical risk management tools through derivatives transactions that are much needed and will not disappear. It is wise for firms with greater regulatory supervision to play a role in this system. However, the ability to net such transactions off each other will be lost because the counterparties will have to interact with a different entity once these derivatives are pushed out. Counterparties will face higher costs and greater operational inefficiencies that will tie up capital. The likely result will be a substantial loss of market share for U.S. firms as these transactions would be shifted to foreign banks.

As the Committee examines legislation related to the derivatives reforms, I strongly urge consideration and support legislation that would repeal Section 716 as a way to address these concerns. I appreciate your attention to this matter and would welcome any further discussion on the topic if you would find that helpful.

Sincerely,

Mark Zandi

Please note: I am chief economist of Moody's Analytics, which is an independent subsidiary of Moody's Corporation. The views I have expressed in this letter are of my own and not those of Moody's Corporation or its subsidiaries.